

No. 77-920

Supreme Court, U. S.
FILED

FEB 7 1978

MICHAEL RODAK, JR., CLERK

In the

Supreme Court of the United States

OCTOBER TERM, 1977

THOR POWER TOOL CO.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for a Writ of Certiorari to the United States
Court of Appeals for the Seventh Circuit

**BRIEF OF THE NATIONAL ASSOCIATION OF
MANUFACTURERS OF THE UNITED STATES
OF AMERICA, AS AMICUS CURIAE
IN SUPPORT OF PETITION**

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The National Association of Manufacturers of the United States of America ("NAM"), as *Amicus Curiae* pursuant to consent of the parties under Rule 42 of this Court, respectfully supports the petition of Thor Power Tool Co., praying that a Writ of Certiorari issue to the United States Court of Appeals to review its judgment in *Thor Power Tool Co. v. Commissioner of Internal Revenue*, 563 F.2d 861 (1977). The issue in that decision to

which this brief is directed is not a technical tax issue affecting a minor segment of the tax population, but is an issue of national importance involving a great number of dollars. This brief will not rehash the arguments ably made by the Petitioner in its brief; its purpose is to highlight the significance of the issue and to point out some critical errors and deficiencies in the decision of the court below. The issue is whether the Commissioner of Internal Revenue ("the Commissioner"), under Section 471 of the Internal Revenue Code of 1954 ("the Code"), has the discretion to disallow for income tax purposes write-downs of excess inventories to realizable values when such write-downs are required for financial reporting purposes under generally accepted accounting principles.

INTEREST OF THE NAM

The NAM, a New York corporation not for profit, is an organization exempt from Federal income taxation under Code §501(c)(6) as a business league. It is a trade association which represents the common business interests of more than 13,000 manufacturing corporations.

A very substantial number of the members of the NAM value their inventories under the valuation method known as "cost or market, whichever is lower," which method is specifically authorized under Treas. Regs. §1.471-4, and have for many years written down the values of their inventories to reflect the presence of "excess inventories," i.e., inventories held in quantities exceeding those which can be sold, as required to comply with generally accepted accounting principles.

These write-downs of inventories, which are required in order to obtain a profit and loss statement certified by a

certified public accountant, and thus also required by the Securities and Exchange Commission under Section 19(a) of the Securities Act of 1933,¹ have been for many years allowed by the Internal Revenue Service in the computation of taxable income.

Should the Seventh Circuit's decision in the *Thor* case, which the Internal Revenue Service regards as applicable to all taxpayers, not be reversed by this Court, these members of the NAM, as well as countless other taxpayers engaged in non-manufacturing activities, will be adversely and substantially affected.

The imposition of extensive retroactive tax liabilities upon income which will never be realized will result either in heavy financing costs or in uneconomical scrapping of inventories, either of which will cause substantial and unnecessary price increases.

¹ Thor's failure in prior years to write down its excess and obsolete inventories resulted in the filing of three lawsuits against Thor and its former independent accountants (*Sweeney v. Thor Power Tool Co., Stewart Warner Corp., et al.*, Circuit Court of Cook County, Illinois, No. 65 CH 1971; *Drake v. Thor Power Tool Co., Stewart Warner Corp., et al.*, U.S. District Court, N. Dist. Ill., E. Div., No. 65 C 1133; and *Greenwald v. Thor Power Tool Co., Stewart Warner Corp., et al.*, District Court, N. Dist. Ill., E. Div., No. 65 C 1928), a lawsuit by Thor against its former management (*Thor Power Tool Co. v. Hurley*, Circuit Court of Cook County, Illinois, No. 65 C 2973), and an investigation by the Securities and Exchange Commission.

ARGUMENT

I.

This is not a technical tax issue involving a small number of taxpayers. It is an issue of national importance. The Internal Revenue Service has informed counsel for NAM that there are presently 371 cases docketed in the United States Tax Court, in which this issue is the principal issue, involving \$25,266,992 of tax deficiencies, and that there are 493 cases pending in the Appellate Division of the Internal Revenue Service, involving an unknown dollar amount of deficiencies asserted and refunds claimed. While no figures have been furnished with respect to cases pending in the Audit Division of the Internal Revenue Service, it is no exaggeration to state that the Audit Division, whose caseload is many times that of the Appellate Division, must have pending cases on this issue involving at least \$100,000,000 of deficiencies, and probably more.² Given the limited audit capacity of the Service, these pending cases, substantial as they are, probably represent only the "tip of the iceberg."

In any event, the fact that five expert witnesses from four of the largest firms of certified public accountants testified in this case that such inventory write-downs were required under generally accepted accounting principles and that the failure to make such write-downs would preclude the certification of financial statements, adequately demonstrates that this issue is one of major significance to the national business community.

² Most cases involving this issue have been suspended in the Audit Division for many years, awaiting the ultimate outcome of the *Thor* case.

II.

Moreover, entirely apart from the major and adverse economic effects of the *Thor* decision on this issue, a question of grave importance in tax administration is presented: If, as the Court of Appeals for the Seventh Circuit held, the Commission has unbridled discretion under Code §471 to disallow an inventory valuation method which is required by generally accepted accounting principles, by simply asserting that such method does not clearly reflect income for tax purposes, has not the requirement of Code §471 that the method must conform to the "best accounting practice in the trade or business" been written out of the statute?

The pathway to this decision commences with a statement that Code §471 contains a "two-part standard" on which the Commissioner must act regarding inventory methods ("best accounting practice in the trade or business" and "most clearly reflecting the income"), as opposed to the single standard presented in Code §446 dealing with accounting methods in general ("clearly reflect income"). From this statement, the peculiar conclusion is drawn that this means the Commissioner's discretion is greater with respect to inventory methods than it is with respect to accounting methods in general (A-39).³ Having so concluded, the court below then stated, on the authority of a group of factually irrelevant cases, that the Commissioner's determination that an inventory method reflecting the "best accounting practice" does not clearly reflect taxable income must be upheld unless "plainly arbitrary" (A-40).

Next, the court below held that the inventory method in issue was not sanctioned by specific regulations (A-42-44), that the provision in the Treasury Regulations that an inventory method conforming to the "best accounting prac-

³ The references are to the Appendix to Thor's petition for *Certiorari*.

tice" in a business ordinarily results in a clear reflection of income was nullified by a lack of consistency in the application of the method (A-44-45), and that the Commissioner's determination was not an abuse of discretion, because Thor had no one testify that its method clearly reflected *taxable income* (A-45-46)—the issue the court was supposed to decide.

Finally, the court observed that it was not an abuse of discretion for the Commissioner to require that excess inventories be scrapped before their losses in value may be reflected in taxable income, under the theory that since the "lower-of-cost-or-market" method of inventory valuation is an exception to the general rule in taxation of requiring "closed transactions" or "identifiable events" for the realization of losses, the Commissioner is free to qualify the use of that method in any way he chooses (A-46-47).

Rather than rehash the arguments ably presented by the Petitioner in its brief, the NAM merely wishes to point out a few critical errors in the decision of the court below.

It should be self-evident that since Code §471 contains two standards governing the discretion of the Commissioner, and since Code §446 contains only one, the discretion of the Commissioner is more restricted under Code §471 than it is under Code §446, and that the cases cited by the court below in support of its conclusion that the Commissioner's action could not be set aside unless "plainly arbitrary," which arose principally under Code §446, are not controlling.⁴

⁴ Additionally, as the Petition points out on page 19, none of the cited cases involved accounting methods which were in accordance with generally accepted accounting principles.

The court below, as well as the Tax Court, misinterpreted the "two-part standard" of Code §471, leading it to conclude that the "best accounting practice" standard was within the province of the accounting profession, while the "clearly reflecting the income" standard was within the uncontrolled discretion of the Commissioner. While there may have been, at the time the Revenue Act of 1918 initiated the language of Code §471, some divergencies between the best accounting practices in some businesses and the clear reflection of income, the development in the meantime by the accounting profession of generally accepted accounting principles, and the shift of emphasis, under those principles, from reasonableness and accuracy of balance sheet presentation to reasonableness and accuracy of the income statement, mean that, as recognized by the Treasury Regulations,⁵ an inventory method which is in accordance with generally accepted accounting principles will ordinarily result in a clear reflection of income. They mean, in short, that the Commissioner's discretion in this area is, in fact, exceedingly narrow.

The court below held that the regulatory presumption that an inventory method in accordance with generally accepted accounting principles would clearly reflect income

⁵ The Internal Revenue Service, in commenting upon proposed changes in the regulations under Code §446, stated, in I.R.S. News Release No. 1186, December 15, 1971, 727 CCH Standard Federal Tax Reporter ¶6291: "Also the terminology 'generally recognized and accepted income tax accounting principles' is changed to 'generally accepted accounting principles' to emphasize that the Internal Revenue Service will, whenever possible, consistent with the requirement that methods of accounting for tax purposes 'clearly reflect income' and be in accordance with other provisions of the Internal Revenue Code, follow principles adopted by the accounting profession in accounting for inventories."

was "dissipated" by an "inference" in the Tax Court opinion that Thor had been inconsistent in the use of this method. Entirely apart from the questionable nature of a conclusion based upon an untried issue, it is clear that the Commissioner's disallowance of the inventory method used by Thor was not based upon lack of consistency. Twelve days after the date of the decision in the court below, Revenue Ruling 77-364, I.R.B. 1977-41, p. 9, was issued, holding that a percentage write-down of excess inventories was not an acceptable method of inventory valuation, in a factual situation where the taxpayer consistently used such method. Obviously, the court below was misled as to the basis for the Commissioner's determination.⁶

As noted above, the final argument constructed by the court below was that the Commissioner was free to accept, in a limited manner, "the lower-of-cost-or-market" method of inventory valuation, by requiring, in the case of excess inventories, that they be valued at cost until scrapped. In essence, this finding means that the Commissioner is free to disregard "the best accounting practice in the trade or business," which is to value excess inventories at realizable value.

In other words, the court below held that the Commissioner, by virtue of his long-standing failure to provide in the regulations for the specific treatment of excess inventories under the "lower-of-cost-or-market" method of inventory valuation, was free to disregard the statute.

⁶ Indeed, the Commissioner's notice of deficiency determined that the write-down of excess inventories was disallowed as not qualifying as a business expense under Code §162 (A-17). The thought of invoking Code §471 did not occur until shortly before the case was tried in the Tax Court.

He need not state why an inventory method which clearly reflects financial income fails to clearly reflect taxable income; he needs only to remain silent. He need not demonstrate why a valuation at cost until scrapping will most clearly reflect income; he needs only to say that the method which is in accordance with generally accepted accounting principles is unacceptable to him.

Once the "best accounting practice" stricture has been removed—and this stricture was deliberately added by Congress⁷—the same result is observed in the inventory area as has occurred in other areas of broad administrative discretion. The method of valuation which "clearly" reflects income has been held by the Commissioner to be whatever method "early" reflects the income.

⁷ The phrase was added to the House version of Section 203 of the Revenue Act of 1918 by the Senate, and adopted in conference. H.Rep. No. 1037, 65th Cong., 3rd Sess., p. 45, 1939-1 C.B. (Part 2) 132.

CONCLUSION

The judgment of the court below, which, contrary to Code §471, confers a broad discretion upon the Commissioner to disregard generally accepted accounting principles of inventory valuation, is not only incorrect, but an unconscionable retroactive financial burden for American business. The NAM urges that a writ of *certiorari* issue to review this judgment.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on February 3, 1978, I served three copies of this Brief for the National Association of Manufacturers of the United States of America, as *Amicus Curiae*, in support of the Petition for a Writ of *Certiorari* by Thor Power Tool Co., upon each of the parties to this proceeding by depositing the same, enclosed in a sealed envelope with first class postage thereon fully prepaid, in a United States mail box at Chicago, Illinois, addressed to the attorneys for the parties as follows:

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